

REPORT OF EXAMINATION  
OF THE  
FIRST AMERICAN SPECIALTY  
INSURANCE COMPANY

AS OF  
DECEMBER 31, 2010

Filed December 22, 2011.

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Los Angeles, California  
October 13, 2011

Honorable Dave Jones  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

FIRST AMERICAN SPECIALTY INSURANCE COMPANY

(hereinafter also referred to as the Company) at its statutory home office located at 114 East Fifth Street, Santa Ana, California 92701.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2007. This examination covers the period from January 1, 2008 through December 31, 2010. The examination was conducted in accordance with the National Association of Insurance Commissioners' Financial Condition Examiners' Handbook. The Handbook requires the planning and performance of the examination to evaluate the Company's financial condition, to identify prospective risks, and to obtain information about the Company, including corporate governance, identification and assessment of inherent risks, and the evaluation of the system controls and procedures used to mitigate those risks. The examination also included an assessment of the principles used and the significant estimates made by management, as well as an evaluation of the overall financial statement presentation, and management's compliance with Statutory Accounting Principles and Annual Statement instructions. All accounts and activities of the Company were considered in accordance with the risk-focused examination process.

This examination was conducted concurrently with its affiliate, First American Property & Casualty Insurance Company. The examination was also a coordinated examination and was conducted concurrently with other insurance entities in the holding company group.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; pensions, stock ownership and insurance plans; growth of company; loss experience; statutory deposits; and sales and advertising.

### SUBSEQUENT EVENTS

On September 1, 2011, the Company paid a \$12 million ordinary cash dividend to its parent, First American Financial Corporation.

### COMPANY HISTORY

The Company, formerly known as Five Star Insurance Company (FSIC), was incorporated under the laws of the State of California on August 1, 1986 and commenced business on May 18, 1987. On October 19, 2000, FSIC changed its name to First American Specialty Insurance Company subsequent to the acquisition of its parent company, Five Star Holdings, Inc. (FS Holdings), by First American Corporation (FAC) in November 1999.

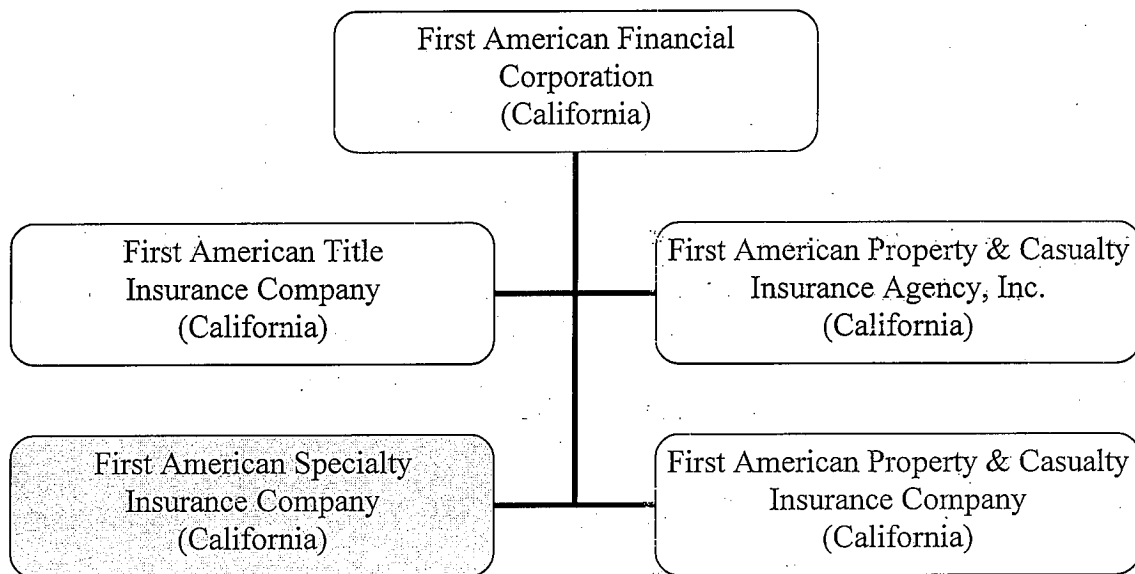
Pursuant to an Agreement and Plan of Merger dated May 13, 2009, FAC merged FS Holdings into itself. As a result, the Company became a direct wholly-owned subsidiary of FAC. Effective June 1, 2010, FAC was reorganized into two independent public companies, First American Financial Corporation (FAFC) and CoreLogic, Incorporated. At that time, the Company became a wholly-owned subsidiary of FAFC.

In November 2010, the Company received a \$600,000 surplus contribution from its parent, FAFC, as part of the reorganization plan.

During the examination period, the Company paid ordinary dividends consisting of cash, bonds, and stocks to its parent as follows: \$5 million in 2008, \$8 million in 2009, and \$6.6 million in 2010.

### MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of First American Financial Corporation, a California corporation. The following abridged organizational chart depicts the Company's relationship within the holding company system:



All ownership is 100%

Members of the board of directors, who are elected annually, manage the business and affairs of the Company. Following are members of the board and principal officers of the Company serving on December 31, 2010:

## Directors

### Name and Residence

### Principal Business Affiliation

James John Court  
Laguna Niguel, California

Secretary, Chief Information Officer, and  
Chief Operating Officer  
First American Property & Casualty Insurance  
Company  
First American Specialty Insurance Company

Dennis Joseph Gilmore  
Corona Del Mar, California

Chief Executive Officer  
First American Financial Corporation

George Joseph Grupp  
Mission Viejo, California

Treasurer and Chief Financial Officer  
First American Property & Casualty Insurance  
Company  
First American Specialty Insurance Company

Parker Steven Kennedy  
Orange, California

Chairman of the Board  
First American Financial Corporation

Dirk Randal McNamee  
Corona Del Mar, California

President  
First American Property & Casualty Insurance  
Company  
First American Specialty Insurance Company

Jeffrey Scott Robinson  
Lake Forest, California

Associate General Counsel  
First American Financial Corporation

## Principal Officers

### Name

### Title

Dirk Randal McNamee  
George Joseph Grupp

President  
Executive Vice President, Chief Financial  
Officer, and Treasurer

James John Court

Vice President, Chief Information Officer,  
Chief Operating Officer, and Secretary

## Management Agreements

Management and Services Agreement: The Company and its affiliates are parties to a Management and Services Agreement, effective January 1, 2006. Under the terms of the agreement, First American Title Insurance Company and the Company may provide services to any party to the agreement. The services may include, but are not limited to, accounting, tax and auditing, accounts receivable, actuarial, asset disposition, corporate, data processing, external, internal and regulatory communications, human resources, litigation, payroll, treasury, and investment support. The Company provides services to First American Property & Casualty Insurance Company and First American Property & Casualty Insurance Agency, Inc. (FAPCIA) for which the Company is reimbursed for actual expenses incurred on a monthly basis. Payments received for 2008, 2009, and 2010 were \$10.4 million, \$11.6 million, and \$10.6 million, respectively. The agreement was approved by the California Department of Insurance (CDI) on January 25, 2006.

Agency Agreement: The Company entered into an Agency Agreement with its affiliate, FAPCIA, effective January 1, 2009. This agreement replaced a similar agreement dated January 1, 2001. Under the terms of the current agreement, FAPCIA underwrites policies on behalf of the Company. The Company collects premiums directly from customers and pays commissions to FAPCIA monthly based on cash collections. The Company pays FAPCIA a commission of 15% for flood and 17% for all other lines of business. The Company failed to file the agreement with the CDI for approval in accordance with California Insurance Code (CIC) Section 1215.5(b)(4). It is recommended that the Company file the agreement with the CDI for approval. This was also recommended in the prior examination report.

Tax Allocation Agreement: The Company and its affiliates are parties to a Tax Allocation Agreement with its ultimate parent, First American Corporation (FAC). The Company became a party to the agreement on October 18, 2001 subsequent to its acquisition by FAC. Under the terms of the agreement, allocation of taxes is based upon separate return calculations with inter-company tax balances settled in the quarter subsequent to the filing of the consolidated return. The Company failed to file the agreement with the CDI for approval in accordance with CIC Section 1215.5(b)(4).

It is recommended that the Company file the agreement with the CDI for approval. This was also recommended in the prior examination report. The Company has advised the CDI that a new agreement is being drafted as a result of the reorganization and mergers.

### TERRITORY AND PLAN OF OPERATION

As of December 31, 2010, the Company was licensed to transact multiple lines of property and casualty insurance business in the following four states: Arizona, California, Nevada, and New York.

The Company offers primarily homeowner and dwelling fire insurance marketed through an affiliated general agent, First American Property & Casualty Insurance Agency, Inc., and through a network of independent agents and brokers. Of the \$63.2 million in direct premiums written in 2010, \$63 million (99.7%) was written in California with the remainder written in New York.

### REINSURANCE

#### Assumed

The Company does not assume any reinsurance.

#### Ceded

The following is a summary of the principal ceded reinsurance treaties in force as of December 31, 2010:



Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Limits
Property Facultative	General Reinsurance Corporation	\$1.5 million per risk	\$6.0 million all risk per occurrence
1 <sup>st</sup> Property Catastrophe Excess of Loss	Various Authorized and Unauthorized	\$5 million per occurrence	\$15 million in excess of \$5 million per occurrence
2 <sup>nd</sup> Property Catastrophe Excess of Loss	Various Authorized and Unauthorized	\$20 million per occurrence	\$20 million in excess of \$20 million per occurrence
3 <sup>rd</sup> Property Catastrophe Excess of Loss	Various Authorized and Unauthorized	\$40 million per occurrence	\$60 million in excess of \$40 million per occurrence

As of December 31, 2010, reinsurance recoverables for all ceded reinsurance totaled \$231,000 or 0.5% of surplus as regards policyholders. Of the ceded reinsurance recoverables, 23.4% were from non-affiliated authorized reinsurers.

### ACCOUNTS AND RECORDS

An analysis of the detail claims listing as of December 31, 2010 disclosed various claims that were closed but still had reserve activity. The Company stated that it currently runs monthly reports to identify these claims. It is recommended that the Company establish and implement procedures and quality control tests to ensure that all information contained in its detail claims listing are accurate.

It was noted during the examination that the Company did not properly report some of the support schedules and account balances in accordance with the National Association of Insurance Commissioners' (NAIC) Annual Statement Instructions. It is recommended that the Company implement controls to identify potential errors and properly review its statutory financial statements for compliance with NAIC Annual Statement Instructions before they are submitted to the California Department of Insurance.

## FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2010

Underwriting and Investment Exhibit for the Year Ended December 31, 2010

Reconciliation of Surplus as Regards Policyholders from December 31, 2007  
through December 31, 2010

Statement of Financial Condition  
as of December 31, 2010

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 86,280,387	\$	\$ 86,280,387	
Preferred stocks	1,892,565		1,892,565	(1)
Common stocks	3,522,310		3,522,310	
Cash and short-term investments	6,857,253		6,857,253	
Investment income due and accrued	904,934		904,934	
Premiums and considerations:				
Uncollected premiums and agents' balances in the course of collection	19,580		19,580	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	3,754,365		3,754,365	
Reinsurance:				
Amounts recoverable from reinsurers	25,537		25,537	
Current federal income tax recoverable and interest thereon	212,864		212,864	(2)
Net deferred tax asset	2,972,714		2,972,714	
Electronic data processing equipment and software	294,525	294,525	0	
Furniture and equipment	47,198	47,198	0	
Receivables from parent, subsidiaries and affiliates	503,514		503,514	
Aggregate write-ins for other than invested assets	<u>25,443,024</u>	<u>25,188,031</u>	<u>254,993</u>	
Total assets	<u>\$ 132,730,770</u>	<u>\$ 25,529,754</u>	<u>\$ 107,201,016</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 12,320,650	(3)
Loss adjustment expenses			3,393,946	(3)
Commissions payable, contingent commissions and other similar charges			1,321,054	
Other expenses			4,492,250	(4)
Taxes, licenses and fees			298,207	
Unearned premiums			32,037,778	
Funds held by company under reinsurance treaties			15,702	
Amounts withheld or retained by company for account of others			738,116	
Drafts outstanding			1,561,567	
Payable to parent, subsidiaries and affiliates			<u>172,165</u>	
Total liabilities			56,351,434	
Common capital stock		\$ 2,000,000		
Gross paid in and contributed surplus		11,770,000		
Unassigned funds (surplus)		<u>37,079,582</u>		
Surplus as regards policyholders			<u>50,849,582</u>	
Total liabilities, surplus and other funds			<u>\$ 107,201,016</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2010

Statement of Income

Underwriting Income

Premiums earned		\$ 61,431,287
Deductions:		
Losses incurred	\$ 24,441,389	
Loss adjustment expenses incurred	3,190,021	
Other underwriting expenses incurred	<u>19,373,574</u>	
Total underwriting deductions		<u>47,004,984</u>
Net underwriting gain		14,426,303

Investment Income

Net investment income earned	\$ 3,745,366	
Net realized capital gain	<u>1,620,740</u>	
Net investment gain		5,366,106

Other Income

Net loss from agents' or premium balances charged off	\$ (54,828)	
Finance and service charges	<u>159,648</u>	
Total other income		<u>104,820</u>
Net income before federal income taxes		19,897,229
Federal income taxes incurred		<u>6,964,030</u>
Net income		<u>\$ 12,933,199</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2009		\$ 43,403,956
Net income	\$ 12,933,199	
Change in net unrealized capital gains	406,255	
Change in nonadmitted assets	215,229	
Surplus adjustments: Paid in	600,000	
Dividends to stockholders	(6,600,000)	
Aggregate write-ins for gains in surplus	<u>(109,057)</u>	
Change in surplus as regards policyholders for the year		<u>7,445,626</u>
Surplus as regards policyholders, December 31, 2010		<u>\$ 50,849,582</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2007 through December 31, 2010

Surplus as regards policyholders, December 31, 2007 per Examination			\$ 40,408,798
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 28,013,395	\$	
Change in net unrealized capital losses		534,896	
Change in nonadmitted assets		25,410,826	
Change in provision for reinsurance	475,303		
Surplus adjustments: Paid in	600,000		
Dividends to stockholders		19,600,000	
Aggregate write-ins for gains in surplus	<u>26,897,808</u>		
Total gains and losses	<u>\$ 55,986,506</u>	<u>\$ 45,545,722</u>	
Net increase in surplus as regards policyholders			<u>10,440,784</u>
Surplus as regards policyholders, December 31, 2010, per Examination			<u>\$ 50,849,582</u>

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Preferred Stocks

The Company did not properly report its preferred stocks with National Association of Insurance Commissioners' (NAIC) designations 3 to 6 at the lower of cost or fair value in accordance with Statement of Statutory Accounting Principles (SSAP) 32, paragraph 19. Subsequently, the securities were either sold or properly reported in the June 30, 2011 quarterly filing. It is recommended that the Company continue to comply with SSAP 32, paragraph 19.

### (2) Current Federal Income Tax Recoverable and Interest Thereon

The captioned asset consists of amounts due from its parent as a result of overpayment of estimated quarterly taxes. There has been no tax settlement with its parent since 2005. SSAP 25, paragraph 6, states, in part, that amounts owed to the reporting entity over 90 days from the written agreement due date shall be non-admitted. It is recommended that tax settlements are made in a timely manner in accordance with the Tax Allocation Agreement. It is also recommended that the Company non-admit any tax recoverables that are over 90 days due in accordance with SSAP 25, paragraph 6.

### (3) Losses and Loss Adjustment Expenses

The Company's reserves were evaluated by a Casualty Actuary from the California Department of Insurance (CDI). Based on the CDI analysis, the Company's December 31, 2010 reserves for losses and loss adjustment expenses appear reasonable and have been accepted for purposes of this examination.

### (4) Other Expenses

Advance premiums in the amount of \$1,533,651 were improperly included in the captioned liability account. It is recommended that the Company record advance premiums as a separate liability in accordance with SSAP 53, paragraph 13 and the NAIC Annual Statement Instructions.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Management and Control – Management Agreements: Agency Agreement (Page 5): The Company failed to file the agreement with the California Department of Insurance (CDI) for approval in accordance with California Insurance Code (CIC) Section 1215.5(b)(4). It is recommended that the Company file the agreement with the CDI for approval. This was also recommended in the prior examination report.

Management and Control – Management Agreements: Tax Allocation Agreement (Page 5): The Company failed to file the agreement with the CDI for approval in accordance with CIC Section 1215.5(b)(4). It is recommended that the Company file the agreement with the CDI for approval. This was also recommended in the prior examination report. The Company has advised the CDI that a new agreement is being drafted as a result of the reorganization and mergers.

Accounts and Records (Page 7): It is recommended that the Company establish and implement procedures and quality control tests to ensure that all information contained in its detail claims listing are accurate.

Accounts and Records (Page 7): It is recommended that the Company implement controls to identify potential errors and properly review its statutory financial statements for compliance with the National Association of Insurance Commissioners' (NAIC) Annual Statement Instructions before they are submitted to the CDI.

Comments on Financial Statement Items – Preferred Stocks (Page 12): It is recommended that the Company continue to report preferred stocks with NAIC designations 3 to 6 at the lower of cost or fair value in accordance with Statement of Statutory Accounting Principles (SSAP) 32, paragraph 19.

Comments on Financial Statement Items - Current Federal Income Tax Recoverable and Interest Thereon (Page 12): It is recommended that tax settlements are made timely in accordance with the Tax Allocation Agreement. It is also recommended that the Company non-admit any tax recoverables that are over 90 days due in accordance with SSAP 25, paragraph 6.

Comments on Financial Statement Items – Other Expenses (Page 12): It is recommended that the Company record advance premiums as a separate liability in accordance with SSAP 53, paragraph 13 and the NAIC Annual Statement Instructions.

#### Previous Report of Examination

Management and Control – Affiliated Management Agreements: Tax Allocation Agreement (Page 5): It was recommended that the Company file this agreement with the California Department of Insurance (CDI) for approval to comply with California Insurance Code (CIC) Section 1215.5(b)(4). The Company has not complied. The Company has advised the CDI that a new agreement is being drafted as a result of the reorganization and mergers.

Management and Control – Affiliated Management Agreements: Agency Agreement (Page 5): It was recommended that the Company file this agreement with First American Property & Casualty Insurance Agency, Inc. with the CDI for approval to comply with CIC Section 1215.5(b)(4). The Company has not complied.

Reinsurance – Ceded (Page 6): It was recommended that the Company amend its reinsurance intermediary agreement to comply with CIC Section 1781.5 and Title 10, California Code of Regulations Section 2303. The Company has complied.



## ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

\_\_\_\_\_/S/\_\_\_\_\_  
Deanna Lo, CFE  
Examiner-In-Charge  
Senior Insurance Examiner  
Department of Insurance  
State of California